

Office of Chief Counsel
Internal Revenue Service

memorandum

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date: **JAN 13 2000**

to: Chief, Appeals Division, North-South Carolina District
Attn: Appeals Officer Martha Metz

from: District Counsel, North-South Carolina District, Greensboro

subject: Capitalization versus Deduction of "Bonus Interest" Paid to
Depositors of Acquired Savings Bank
Taxpayer: [REDACTED]
Taxable Years: [REDACTED] and [REDACTED]

DISCLOSURE STATEMENT

This advice constitutes return information subject to I.R.C. § 6103. This advice contains confidential information subject to attorney-client and deliberative process privileges and if prepared in contemplation of litigation, subject to the attorney work product privilege. Accordingly, the Examination or Appeals recipient of this document may provide it only to those persons whose official tax administration duties with respect to this case require such disclosure. In no event may this document be provided to Examination, Appeals, or other persons beyond those specifically indicated in this statement. This advice may not be disclosed to taxpayers or their representatives.

This advice is not binding on Examination or Appeals and is not a final case determination. Such advice is advisory and does not resolve Service position on an issue or provide the basis for closing a case. The determination of the Service in the case is to be made through the exercise of the independent judgment of the office with jurisdiction over the case.

By your memorandum of November 10, 1999, we were asked to provide a legal opinion regarding the above-referenced matter.

ISSUE

UIL No. 263.00-00. Whether amounts denominated "bonus interest," paid to the depositors of a savings bank in order to facilitate the acquisition of that bank, are currently deductible or constitute nondeductible capital expenditures.

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CONCLUSION

The bonus interest payments constitute nondeductible capital expenditures.

FACTS

██████████ ("██████"), a North Carolina corporation registered as a bank holding company, wished to acquire ██████████ ("██████") to hold as a subsidiary. ██████████ was chartered under North Carolina law as a mutual savings bank. Accordingly, it was necessary for ██████████ to convert to a stock company in order to enable the acquisition by ██████████.

On ██████████, ██████████'s Board of Directors adopted a Plan of Stock Conversion, and on ██████████ ██████████ and ██████████ entered into an Acquisition Agreement. The Acquisition Agreement provided that, subject to approval by the Administrator of the North Carolina Savings Institutions Division and by ██████████'s members, ██████████ would convert from a mutual savings bank to a North Carolina-chartered stock savings bank, and concurrently therewith become a wholly-owned subsidiary of ██████████.¹

The Acquisition Agreement as originally entered into between the parties did not contain any provision for payment of "bonus interest" to ██████████'s depositors. However, on ██████████ ██████████, that agreement was amended to provide that (a) each depositor of ██████████ as of ██████████ would receive a bonus interest payment of an additional ██████████ percent on the ██████████ deposit balance, to be paid immediately after the closing of the acquisition transaction, and (b) each depositor of ██████████ as of one year after the closing of the acquisition would receive an additional bonus interest payment of one percent on the lesser of the average daily account balance for the year following the acquisition or the account balance as of ██████████.

On ██████████ (the day after the bonus interest amendment to the Acquisition Agreement), at a special meeting of ██████████'s members a majority voted to approve the conversion of

¹ ██████████ served as the holding company for ██████████ ██████████, a North Carolina commercial bank. The Acquisition Agreement states that ██████████ would maintain ██████████ as a separate North Carolina-chartered savings bank subsidiary for at least three years, but intended at some time thereafter to merge or consolidate ██████████ into ██████████ or another commercial bank subsidiary of ██████████.

██████ to a stock savings bank and its simultaneous acquisition by ██████. On ██████, the Administrator of the North Carolina Savings Institutions Division approved those transactions. The conversion and acquisition occurred on that date, and on ██████ an amended certificate of incorporation for ██████, reflecting its conversion to a stock bank, was filed with the North Carolina Secretary of State.

However, not all of ██████'s members were happy with the changes to that bank, and on ██████ two depositors began the process of administratively contesting the conversion and acquisition.² When those efforts were unsuccessful, the dissidents in ██████ instituted a legal action to overturn the conversion and acquisition. That action ultimately was resolved in ██████ by a settlement agreement providing for increased bonus interest payments.

The first bonus interest payment (████████ percent as provided for under the amendment to the Acquisition Agreement) had been made to ██████'s depositors on ██████. Under the settlement agreement, the bonus interest payment to be made on ██████ was to be calculated on the balance in each depositor's account on ██████ (rather than on the lesser of the amount on deposit on that date or the average daily balance in each depositor's account from ██████ to ██████), and was payable regardless of whether the depositor maintained an account with ██████ after ██████. Also, under the settlement agreement each depositor of ██████ as of ██████ was to be paid on ██████ an additional ██████-percent interest bonus based on the depositor's account balance as of ██████, regardless of whether the depositor thereafter maintained an account with ██████.

For each of the years in question, ██████ joined in a consolidated return with ██████ as the common parent. On those returns ██████ claimed deductions for the bonus interest payments. Upon audit of the ██████ and ██████ returns, the Examination Division determined that the bonus interest constituted nondeductible capital expenditures.³ The taxpayer contends that the bonus interest payments are deductible as

² The bonus interest amendment to the Acquisition Agreement apparently was aimed at "sweetening" the deal for ██████'s members so as to avoid a challenge. It did not accomplish that purpose.

³ The Service apparently did not disturb the deduction claimed for the bonus interest paid in ██████ and deducted on the return for that year.

interest under I.R.C. § 163, or, alternatively, as ordinary and necessary business expenses under I.R.C. § 162.

DISCUSSION

We do not agree with the taxpayer's contentions.

First of all, the bonus interest payments in question do not constitute interest. As stated at page 5 of the taxpayer's protest, interest constitutes the amount which one has contracted to pay for the use, forbearance, or detention of money. However, the bonus interest paid by [REDACTED] was based solely on amounts on deposit on [REDACTED], without regard to whether such amounts were on deposit before or after that date. Thus, the payments were not in consideration of the use of the depositors' money for any period of time. Also, the obligation to make the payments did not arise until well after the date ([REDACTED]) with respect to which the bonus interest amounts were calculated. Such obligation was not contractual in nature, but rather was undertaken in settlement of a lawsuit seeking to undo the conversion and acquisition. The lawsuit apparently was not based on any contention that interest paid to depositors for use of their money was insufficient. The bonus interest was paid to resolve the challenge to the conversion and acquisition transactions by "sweetening up" the deal for [REDACTED]'s members.⁴ Although couched in terms of a percentage to be applied to amounts of deposits as of [REDACTED], the payments were made to finalize the conversion and acquisition, and not to compensate the depositors for the use of their money.⁵

Thus, to the extent the "origin of the claim" doctrine⁶ has pertinence to this case, the origin of the claim pursuant to which the bonus interest was paid was the conversion and acquisition itself, and not the right of [REDACTED]'s depositors to be compensated for the use of their money. The Acquisition

⁴ A mutual savings bank is "owned" by its members (i.e., its depositors).

⁵ Also, since depositors were entitled to the bonus interest regardless of their account status after [REDACTED], it apparently was not paid as an incentive to the depositors to continue their relationship with [REDACTED].

⁶ Under that doctrine the character of an expenditure is determined by the transaction or activity from which it proximately resulted. See Woodward v. Commissioner, 397 U.S. 572 (1970); United States v. Gilmore, 371 U.S. 39 (1963).

Agreement and the proxy statement relating to the special meeting of [REDACTED]'s members state that [REDACTED]'s board of directors believed that the conversion and acquisition would benefit [REDACTED]. To the extent the bonus interest was paid to benefit [REDACTED] by facilitating the acquisition, it seems analogous to the friendly takeover expenses required to be capitalized in INDOPCO, Inc. v. Commissioner, 503 U.S. 79 (1992).⁷ To the extent the bonus interest may have been paid by [REDACTED] to benefit [REDACTED] by facilitating the acquisition, it would seem to constitute a constructive dividend to [REDACTED]. In either event, based on the facts as we understand them, the bonus interest was paid to facilitate a capital transaction (i.e., the acquisition of [REDACTED] by [REDACTED]), and, under rationale of INDOPCO, Inc., A.E. Staley Manufacturing Co. v. Commissioner, 119 F.3d 482 (7th Cir. 1997), and cases cited therein, we believe the bonus interest payments constitute nondeductible capital expenditures.⁸

Because this memorandum provides significant legal advice in a large case, pursuant to CCDM (35)3(19)4(4) we are forwarding a copy to the National Office for post-review. The normal turn-around time for such post-review is 10 days. We will inform you of the National Office's response when it is received.

We are returning herewith the attachments forwarded with your memorandum of November 10, 1999. If we may be of further assistance in this matter, please contact Mr. Ross Rowley of this office, telephone extension 2123.


PAUL G. TOPOLKA
District Counsel

Attachments:
As stated

⁷ Any benefits to [REDACTED] presumably would be of indefinite duration.

⁸ Even if the bonus interest otherwise qualified for deduction (e.g., as interest under I.R.C. § 163), under these facts that deduction would be subject to disallowance in favor of capitalization. See I.R.C. §§ 161 and 261; INDOPCO, Inc.